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In the Supreme Court of the United States

October Term, 1965

No. 23

Fribourg Navigation Company, Inc., petitioner

v.

Commissioner of Internal Revenue

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 2–18) are not officially reported. The opinion of the Court of Appeals (R. 76–90) is reported at 335 F. 2d 15.

JURISDICTION

The judgment of the Court of Appeals was entered on July 15, 1964 (R. 91). A timely petition for rehearing (R. 92–98) was denied on August 20, 1964 (R. 99–101). The petition for a writ of certiorari was filed on November 13, 1964, and granted on February 1, 1965 (R. 102). This Court has jurisdiction under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Petitioner purchased a ship in 1955 for $469,000 and sold it in late 1957 for $695,500. Thus at the end of 1957 petitioner knew that its use of the ship had cost it nothing. The question presented is whether in these circumstances petitioner is entitled to a depreciation deduction in 1957.

STATUTES AND REGULATIONS INVOLVED

Section 167 of the Internal Revenue Code of 1954:

> (a) There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business * * *. [26 U.S.C. 167(a).]

Other pertinent portions of the Internal Revenue Code of 1954 and of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, pp. 49–54.

STATEMENT

On December 21, 1955 petitioner purchased the S.S. *Joseph Feuer,* a used Liberty ship, for $469,000. Prior to purchasing the *Feuer,* petitioner requested and received from the Internal Revenue Service a "letter ruling" stating that the Service would accept straight-line depreciation of the ship based on an estimated useful economic life of three years and an estimated value as scrap steel at the end of that period of $54,000. The letter also stated that it was not a binding agreement under Code Section 167(d)

and the useful life was "subject to such change as subsequent experience may warrant."[1]

In its income tax return for the calendar year 1955 petitioner claimed and was allowed a depreciation deduction for the ten-day period from the date of purchase to the end of the year in the amount of \$3,786.50 (\$469,000 less \$54,000$\div$3$\times$$^{10}/_{365}$). In its return for 1956 it claimed and was allowed a depreciation deduction of \$138,585.77 (\$469,000 less \$54,000$\div$3). As a result of these depreciation deductions, the adjusted cost basis of the *Feuer* at the beginning of 1957 (the taxable year here involved) was \$326,627.73.

The original estimates of the *Feuer's* useful life and salvage value, concededly reasonable when made in 1955, were significantly affected by a scarcity of ships resulting from the Suez crisis of 1956–1957. The blocking of the Suez Canal caused a sharp increase in the value of ships of this type. In mid-1957, petitioner contracted to sell the *Feuer* to the Isbrandtsen Co., and on December 23, 1957, delivered the vessel to its new owner, receiving a price of \$695,500. Thus after using the ship for two of the originally estimated three years, petitioner sold it for a price which not only exceeded petitioner's adjusted cost basis for the *Feuer* at the beginning of 1957, but also was substantially in excess of petitioner's original cost of the ship.

Prior to the sale of the vessel, petitioner adopted a

[1] Unless otherwise stated, all references are to the Internal Revenue Code of 1954 and the Regulations thereunder.

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plan of complete liquidation, which it thereafter completed within 12 months, thus qualifying as a tax-free liquidation under 1954 Code Section 337.

On its 1957 tax return petitioner claimed a depreciation deduction for the *Feuer* in the amount of \$135,367.24 (covering the 357½ days of that year prior to the sale of the vessel) computed on the basis of the original estimates of useful life and salvage value. It reported a capital gain on the sale of the *Feuer* of \$504,239.51 (the difference between the \$695,500 selling price and the ship's adjusted cost basis after reduction by the amount of the claimed 1957 depreciation). Petitioner treated this approximately \$504,000 gain on the sale of the *Feuer* as nontaxable under the provisions of Section 337. The Commissioner disallowed the claimed depreciation deduction for 1957, resulting in a corresponding decrease in the nonrecognizable gain. The Tax Court sustained the Commissioner's determination, and the court of appeals affirmed, one judge dissenting. (R. 2–18, 76–90.)

SUMMARY OF ARGUMENT

Petitioner sold the S.S. *Feuer* in December 1957 for more than its original cost. We submit that since at the end of 1957, when petitioner computed its depreciation for that year, it knew that its use of the ship during 1957 had cost it nothing, it is not entitled to a deduction for depreciation. If petitioner were permitted a \$135,000 depreciation deduction, its ordinary income would be reduced by that amount and its gain on sale of the *Feuer* correspondingly increased. Be-

cause petitioner has elected a tax-free 12-month liquidation, however, its gain on sale of the *Feuer* is not taxable.

I

Depreciation is designed to give a taxpayer periodic deductions, the total of which will be as nearly equal as possible to his actual net cost of using an asset. Until the taxpayer disposes of the asset, however, he does not know its actual net cost. In some cases he may obtain only a nominal junk price for it; in others (such as here) he may sell it for more than its original purchase price. In order to give the taxpayer depreciation deductions in the tax periods when the asset is contributing to income, certain estimates are employed. The taxpayer estimates the length of time he will use the asset and the price he will receive on resale at the end of that period. He then computes the asset's estimated net cost and the period over which he should deduct that net cost.

These estimates are, of course, only a subtitute for the actual facts. In order to achieve the overriding purpose of depreciation—giving the taxpayer periodic deductions which are, in total, as close to actual net cost as possible—the estimates should be revised if a substantial change in conditions makes them materially inaccurate. The Regulations provide that the reasonableness of any claim for depreciation will be judged in light of the conditions existing at the end of the tax year in which the deduction is taken and that a taxpayer may never knowingly deduct more depreciation than the net cost of an asset. Treas. Regs. §§ 1.167(b)-0, 1.167(a)-1(a), (c). This, we submit, requires a taxpayer to revise his estimates if at any time they become unreasonable.

The Regulations state a specific example of when such a revision is necessary: If the conditions existing *at the end of any tax year* indicate that the period during which the taxpayer will use an asset is significantly different from his original estimate, he must revise both the estimated useful life and the estimated resale price. Treas. Reg. § 1.167(a)–1(b), (c). This explicit provision applies here. Petitioner sold the *Feuer* in December 1957. When at the end of 1957 petitioner computed its depreciation for that year, it knew that it had used the *Feuer* for a "significant[ly]" shorter period than originally estimated, *i.e.*, two years instead of three. It was thus required to compute its depreciation for 1957 in light of the "conditions known to exist at the end of" that year. Since it had sold the *Feuer* for more than its original purchase price, it was entitled to no depreciation for 1957.

Moreover, even if a substantial change in useful life had not triggered a revision of petitioner's depreciation formula, the general rules that depreciation deductions must be reasonable in light of the conditions known to exist at the end of the tax year in question and that total depreciation may never knowingly exceed net cost would have prevented petitioner from taking any depreciation deduction in 1957. The Regulations state only one exception to this general rule and it has no application here.

This Court also has repeatedly recognized that depreciation is an eminently realistic and practical concept designed to permit periodic deductions which total as nearly as possible the actual net cost of an

asset. The principles enunciated in prior decisions demonstrate that petitioner cannot continue to use an "artificial" or "false assumption" as to the *Feuer's* net cost, however reasonable that estimate may have been when made. Petitioner may not "knowing[ly] distort" income by depreciating an asset below "what reasonably appears to be the price that will be received when the asset is retired." Once the conditions changed petitioner was required (absent the applicability of the one exception in the Regulations) to "adjust" its estimates to reflect "the real sale price and the actual duration of use." Only by the use of "correct" figures can the total depreciation deductions be kept as close as possible to an asset's "actual cost." *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 101, 105; *Hertz Corp.* v. *United States*, 364 U.S. 122, 127.

II

Petitioner's reliance upon "business accounting principles" is misplaced. As this Court has held, commercial accounting practices are not controlling where, as here, they fail clearly to reflect income for tax purposes. Accountants who prepare income statements for investors have a purpose far removed from that of the taxing authorities. The accountants' main interest is to avoid overstating current income from operations, even if this requires an offsetting book entry to a special non-recurring income account. The tax authorities' aim is to give the taxpayer periodic deductions which equal but do not exceed the taxpayer's actual net cost of the asset. The difference in purpose dictates a difference in result.

III

Nor is there merit to petitioner's contention that all increases in an asset's value due to market appreciation are entitled to capital gain treatment, and that such increases may not, therefore, be used to reduce losses in value due to wear and tear. Section 1231 of the Code provides only that if there is any gain on the sale of a depreciable asset, it is, in general, taxed as capital gain. Nothing in the language or legislative history of that section indicates any Congressional intent to affect in any manner the orderly judicial elaboration of the statutory phrase "a reasonable allowance for" "depreciation" or to withdraw the express power to issue "regulations" governing the manner in which the "allowance [for depreciation shall be] computed." 1954 Code § 167.

Moreover, the basic structure of the scheme of depreciation rebuts petitioner's contention that Congress intended taxpayers to get capital gain on all increases in an asset's value due to market appreciation. The first step a taxpayer takes in computing depreciation is to deduct the asset's estimated resale value at the end of its period of use in his business. If the value of such used assets can be expected to increase during this period, he must therefore use the higher expected price. And if at any time thereafter the asset's expected useful life changes significantly, the taxpayer must re-estimate the asset's resale price. Thus any increase in value that can be foreseen either at the time the asset is first acquired or at the time its useful life is recomputed are frozen into the non-depreciable basis of the asset.

The enactment of Code Sections 1245 and 1250 in 1962 and 1964 does not impair the Commissioner's position here. Like Section 1231, they relate to the method of taxing gain, if any, on disposition of depreciable assets, requiring it to be taxed as ordinary income in certain carefully prescribed circumstances. The Committee Reports state that Congress was aware of cases like the instant one and that they did "not intend to affect" them. H. Rep. No. 749, 88th Cong., 1st Sess., p. 103; S. Rep. No. 830, 88th Cong., 2d Sess., p. 133.

IV

Petitioner erroneously claims that there was a long-settled administrative practice opposed to the Commissioner's present position. Before 1942 the Commissioner had no considered and consistent administrative practice. During much of this period the question had no bearing upon tax liability since the gain from sale of depreciable assets constituted ordinary income. To the extent that any practice has developed in the years since 1942, it lends support to the Commissioner's case.

ARGUMENT

I

AT THE END OF 1957 PETITIONER KNEW THAT IT HAD SOLD THE "FEUER" FOR MORE THAN ITS ORIGINAL COST AND THAT ITS USE OF THE SHIP HAD THUS COST NOTHING; HENCE IT WAS NOT ENTITLED TO ANY DEPRECIATION DEDUCTION FOR THAT YEAR

In December 1955, petitioner purchased the *S.S. Feuer* for $469,000. In light of the circumstances

and conditions existing at the time of purchase, petitioner estimated that the vessel would be useful in its business for three years, at which time it would have a resale or salvage value of approximately $54,000. The Commissioner acknowledges that these estimates were reasonable when made. Using the "straight-line" method of depreciation,[2] petitioner took deductions on its 1955 and 1956 tax returns totaling $142,-372. Thus at the beginning of 1957 (the tax year here in question), petitioner's undepreciated cost basis in the *Feuer* was $326,628 (*i.e.,* $469,000 original cost less $142,372 depreciation). In late 1957, petitioner sold the vessel for $695,500, which is more than $200,-000 in excess of its original purchase price and more than $350,000 in excess of its undepreciated cost. The issue presented is whether petitioner is entitled to an additional depreciation deduction of $135,000 for the calendar year 1957, despite the fact that at the end of 1957 petitioner knew that its use of the ship during 1957 had cost it nothing.[3]

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[2] Under the straight-line method the cost of the property less its estimated salvage value is deductible in equal annual amounts over its estimated useful life. Treas. Reg. § 1.167(b)-1.

[3] The *Feuer* was sold for more than its adjusted cost basis at the beginning of 1957, so that under the Commissioner's position no depreciation is allowable for 1957. If, however, an asset is sold for less than its adjusted cost basis at the beginning of the year of sale, only that portion of the otherwise allowable depreciation deduction that would reduce the adjusted basis below the selling price would be disallowed. Rev. Rul. 62-92, 1962-1 Cum. Bull. 29. For example, if petitioner had purchased a ship for $400,000 with an estimated useful life of 3 years and an estimated salvage value of $100,000, it would have been entitled to a straight-line depreciation deduction of

If petitioner is allowed to deduct additional depreciation in 1957, its gain on the sale of the ship will be increased by exactly the amount of the depreciation deduction. Internal Revenue Code of 1954, §§ 1001, 1011, 1012, 1016(a)(2). The depreciation, however, would be an offset against ordinary income while the corresponding increase in gain on sale would generally be capital gain. See Code § 1231. Moreover, in the instant case the result is even more startling than the usual transformation of ordinary income into capital gain. Since petitioner elected a tax-free 12-month liquidation under Section 337 of the Code, its gain from the sale of the *Feuer* was not taxed at all. Thus if petitioner is permitted additional depreciation in 1957, its ordinary income will be reduced by approximately $135,000 without even a corresponding increase in taxable capital gain.

A. DEPRECIATION IS INTENDED TO GIVE A TAXPAYER PERIODIC DEDUCTIONS WHICH SHOULD TOTAL, AS NEARLY AS POSSIBLE, THE ACTUAL NET COST HE HAS INCURRED

The Internal Revenue Code is, in general, designed to permit a business to take deductions for the costs of generating taxable income. A taxpayer's out-of-pocket expenditures for a machine or a ship used in his trade or business are just as much an expense of earning income as are wages or rentals. There are, however, two differences: First, the machine or ship contributes to revenues in more than one tax period,

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$100,000 per year. If petitioner had then sold the ship for $375,000 after a half year of use, it would, under the Commissioner's view, be entitled to a $25,000 depreciation deduction.

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and thus its net cost must be allocated or apportioned between various tax years. Second, the taxpayer does not know, at the time of purchasing the machine or ship, how much the use of the asset will ultimately cost him. Only after the asset has been resold (whether as scrap or as a used operable machine or ship) can its actual net cost to the taxpayer be ascertained with certainty.

Fairness, however, requires that the taxpayer be entitled to periodic deductions in the tax periods when the machine or ship is contributing to income.[4] Thus certain estimates are employed. In light of all the circumstances at the time of acquisition, the taxpayer estimates the period during which he will use the asset in his business (useful life) and the resale value it will have at the end of that period (salvage value). The taxpayer then takes deductions on his income tax returns for a portion of the estimated net cost of the asset (original cost less salvage value) over the period of the estimated useful life. Treas. Reg. § 1.167(a)-1.

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[4] The alternative, of course, would be to deny the taxpayer any depreciation deductions until he sold the asset, at which time he would know exactly how much its use had cost him. Then he could either deduct the entire net cost in the year of sale or deduct a portion of the actual net cost in each of the years of actual use. The former solution would result in a bunching of deductions attributible to a number of years. The latter would require taxpayers to amend perhaps a dozen years' returns every time they sell an asset and is (even aside from the problem of the statute of limitations) too wasteful and complicated a solution. See, *e.g.*, *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365; *Security Mills* v. *Commissioner*, 321 U.S. 281; *Virginian Hotel Corp.* v. *Helvering*, 319 U.S. 523, 526 ("Congress has elected to make the year the unit of taxation.").

If the circumstances existing at the end of any taxable year indicate that the taxpayer's original estimates were materially incorrect, it would make sense, in light of Congress' provision for "a *reasonable* allowance" for depreciation (Code § 167, emphasis added), to revise the depreciation formula for that year and for future years.[5] The Regulations do in fact explicitly provide that the "reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made." The Regulations also state a specific example of such an adjustment: A taxpayer is required to revise both the estimated useful life and the estimated resale price whenever the "conditions known to exist at the end of the taxable year" indicate that the period during which the asset will be used in the taxpayer's business is significantly different than estimated. Treas. Reg.

[5] Because of the well-established principle that income taxes are computed on the basis of the facts existing at the end of the tax year, depreciation deductions for previous years (which were "reasonable" in amount at the time taken) would not be recomputed. See, *e.g.*, *Commissioner* v. *Mutual Fertilizer Co.*, 159 F. 2d 470 (C.A. 5); S. Rep. No. 665, 72d Cong., 1st Sess., p. 29 (1939-1 Cum. Bull. (Part 2) 496, 517); cases cited *supra*, fn. 4. Thus, there is no merit to petitioner's contention that it would be inconsistent to change the depreciation formula only prospectively without also revising depreciation deducted in all past years. Similarly, the changes in the proposed Regulations under the 1954 Code (see American Automotive Br., pp. 26-27, fn. 15, and Appendix B) were designed simply to make it clear that a salvage value estimate accepted as reasonable in a pre-sale year would not be revised "retroactively" to conform with actual salvage value and thus require a "recalculation" of depreciation allowed in pre-sale years.

§§ 1.167(a)-1 (b), (c), 1.167(b)-0. Depreciation for that year and subsequent years shall thereafter be computed in light of the revised estimates.

However, the Regulations state one exception to this general rule: When there is no substantial change in useful life, the depreciation formula will not be revised annually "merely because * * * changes in price levels" have affected the estimated resale price of the assets. Treas. Reg. § 1.167(a)-1(c). This exception makes good practical sense; if it were necessary to adjust the depreciation formula each time price levels rose or fell, a taxpayer would be required to appraise each of his depreciable assets annually. Since such re-estimated salvage values would "at best [still be] * * * merely informed estimates" subject to additional future fluctuations, this regulation was promulgated "to eliminate needless and endless [re-evaluations and] controversies." Rev. Rul. 62-92, 1962-1 Cum. Bull. 29, Appendix, *infra*, pp. 53-54. See also *Cohn* v. *United States*, 259 F. 2d 371, 378 (C.A. 6).

In short, depreciation deductions are designed to give a taxpayer current deductions the total of which will be as nearly equal as possible to the assets' actual net cost. In order to reach this goal the taxpayer's initial estimates of resale price and useful life must be "reasonable" in light of all the facts and circumstances at the time the asset was purchased; and if at the end of any succeeding tax year the estimates become unreasonable, they must be modified (except that when useful life is not being adjusted the esti-

mate of salvage value will not be changed merely because of changes in price levels).

B. THE REGULATIONS PROHIBIT PETITIONER FROM KNOWINGLY TAKING MORE DEPRECIATION DEDUCTIONS THAN THE "FEUER" HAD ACTUALLY COST IT

Applying these clear and fundamental principles to the instant case, we submit that petitioner is not entitled to any depreciation deduction for 1957 (the year in which it sold the *Feuer*) for two independently sufficient reasons:

First, the Regulations require a taxpayer to revise his depreciation formula whenever, in light of "conditions known to exist at the end of the taxable year," "there is a clear and convincing basis" for determining that the taxpayer will use the asset for a "significant[ly]" different period of time than had been estimated. Treas. Reg. § 1.167(a)-1(b); see also Treas. Reg. § 1.167(b)-0. Eight days before the end of its 1957 tax year petitioner sold the *Feuer*. Thus at the end of its 1957 tax year, petitioner had the clearest and most convincing possible evidence that the *Feuer* would not be used in its business for three years, as originally estimated, but that in fact the period of use would be only two years, *i.e.*, one-third shorter.

While the Regulations refer to a revision of the "*estimated* remaining useful life" (Treas. Reg. § 1.167 (a)-1(b), emphasis added), we believe that both the language of the Regulations and the principles on which they are bottomed cover the situation where (as here) at the end of the taxable year the taxpayer

knows the asset's actual useful life, and thus need not estimate anything. A taxpayer is certainly not excused from adjusting an asset's useful life because the circumstances indicating the need for the change are *too* clear, *i.e.,* they support not merely a more accurate estimate but a determination of the actual period of use in the business. The whole purpose of estimating useful life is to get the most accurate approximation possible of the period the taxpayer will use the asset. When the actual period of use is finally known, there is no longer any need to use estimates in computing further depreciation.

Thus at the end of 1957 when petitioner computed its depreciation for that year it knew that the original three-year estimate of the ship's useful life was "significant[ly]" wrong. Consequently, the Regulations required petitioner to revise both the useful life and resale price in light of the information available at the end of 1957.[6]

Second, we believe that petitioner would not be entitled to any depreciation deductions for 1957 even if its sale of the *Feuer* in December 1957 was not a

[6] If (instead of selling the *Feuer* in 1957) petitioner at the end of 1957 had a "clear and convincing basis" for believing that it would sell the *Feuer* in January 1958 for more than its original cost, the Regulations would plainly have required petitioner to revise its estimated useful life and salvage value, thus preventing it from taking any 1957 depreciation. That petitioner's sale took place in December 1957 rather than January 1958 cannot, we submit, produce the result petitioner seeks. Moreover, this demonstrates that amicus is plainly wrong in arguing that if the contract of sale had postponed delivery of the *Feuer* until January 1958 petitioner would have avoided disallowance of its 1957 depreciation (American Automotive br., p. 44).

sufficiently "significant" change in useful life to trigger a redetermination of salvage value. Petitioner's sale of the *Feuer* during 1957 at a price in excess of its depreciated cost at the beginning of the year is sufficient, we submit, to require disallowance of any further depreciation during 1957. The sole purpose of depreciation is to permit the taxpayer to deduct the net or out-of-pocket cost of an asset to him. In an effort to make the total deductions based on the estimates of salvage value and useful life as close to actual net cost as possible, the Regulations have long contained two basic statements of principle (Treas. Reg. § 1.167(b)-0):

1. "Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property."[7] See also Treas. Reg. § 1.167(a)-1(a), (c).

2. "The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made."

These bedrock principles are the foundation for the specific regulation requiring a taxpayer to revise his estimate of useful life if at the end of any tax year his original estimate appears significantly inaccurate.

[7] American Automotive's brief misreads both this Regulation and Treasury Regulation § 1.167(a)-1(a) as barring depreciation below a reasonably "estimated" salvage value. (Br., pp. 24, 12, fn. 4.) Significantly American Automotive proposed so amending the draft regulations (American Br., Appendix B, p. 13a), but its suggestion was not adopted.

While the Regulations do not explicitly so provide, we believe that the basic purpose of the deduction for depreciation and the two statements of principle just quoted would (absent an explicit exemption in the Regulations) require a taxpayer to revise the estimated resale price of an asset any time changed circumstances at the end of a year indicated a resale value significantly different from the original estimate.

However, for the reasons discussed *supra*, p. 14, the Regulations provide that salvage value shall not be revised *"merely because of changes in price levels"* unless the depreciation formula is being re-examined anyway because of a change in useful life. We believe it quite clear that this salutary and eminently practical regulation was not designed to exempt from the usual rule a taxpayer who, like petitioner here, actually sold the asset for more than its undepreciated cost. Such a taxpayer would neither fall within the language of the regulation nor within its purpose. A sale which finally and irrevocably establishes the actual net cost of an asset is far more than a mere change in price levels. The Commissioner's reading of this regulation would not require a taxpayer to revalue his depreciable assets annually; only assets which have been sold would be affected, and they need not be valued since the actual resale price is known. Revision of the salvage value in such circumstances would not merely substitute one rough estimate for another, but would supplant an

estimate of the resale price with the actual and established resale price.[8] See Rev. Rul. 62-92, 1962-1 Cum. Bull. 29; *Cohn* v. *United States,* 259 F. 2d 371, 378 (C.A. 6); and the lower court's opinion in the instant case, 335 F. 2d 15, 18 (C.A. 2).

At the end of 1957, petitioner knew that although it had already (*i.e.,* in 1955 and 1956) deducted $140,000 depreciation, its use of the *Feuer* had cost it nothing. Yet petitioner here argues that it is entitled to additional depreciation in 1957. Petitioner pins this contention on the argument that once it has selected an estimated salvage value which was reasonable at the time chosen (*i.e.,* in 1955), it is not required to change that salvage value. Petitioner completely ignores both the basic principle that depreciation is intended to give the taxpayer deductions which are, in total, as nearly equal to the actual net cost of the asset being depreciated as possible and the explicit prohibition in the Regulations against ever knowingly taking more depreciation deductions than the net cost of the asset being depreciated. Instead petitioner takes a completely artificial and unrealistic view of depreciation.

[8] Nor could petitioner have avoided this result by merely postponing delivery until January 1958. Once it is clearly established by something more than a "mere * * * change in price levels" (*e.g.,* by a contract to sell) that the resale price of an asset is significantly different than estimated, the actual resale price must be used in computing depreciation. See *Smith Leasing Co.* v. *Commissioner,* 43 T.C. 37.

C. THIS COURT'S RECENT DECISIONS CONFIRM THE PROPOSITION THAT DEPRECIATION DEDUCTIONS CANNOT KNOWINGLY BE BASED ON AN "ARTIFICIAL" OR "FALSE ASSUMPTION" AS TO THE "ACTUAL COST OF EMPLOYING THE ASSET"

This Court's recent decisions make it clear that the computation of depreciation is to be done in an eminently reasonable and practical manner in order to reach a common sense result. In both ***Massey Motors, Inc.*** v. ***United States*** and ***Commissioner*** v. ***Evans,*** 364 U.S. 92, the taxpayers had purchased automobiles which they intended from the outset to resell substantially before the end of their physical lives. The taxpayers nevertheless argued (1) that in estimating salvage value they should use the automobiles' expected junk values at the end of their physical lives, and (2) that the estimated net cost so computed should be written off over the assets' estimated physical useful lives. The Commissioner, on the other hand, contended (1) that the taxpayers should realistically compute estimated net cost by using the estimated resale prices the cars would have (as used cars rather than as junk) at the time when the taxpayers actually expected to sell them, and (2) that this estimated net cost should be depreciated over the period the taxpayers actually expected to use the automobiles.

The Court accepted the Commissioner's position. It noted that since the purpose of depreciation is to allocate the "*actual* cost of employing the asset" "to the periods to which it contributes," the total depreciation deductions should equal "only the [original] cost of the asset less the estimated salvage, resale or second-hand value." 364 U.S. at 104, 105, 107 (em-

phasis added). And it emphasized that in estimating "the actual cost of employing the asset," the taxpayer should attempt to come as close as possible to *"the real salvage price and the actual duration of use"*; thus whenever "a mistake has been discovered," an "adjustment" must be made in the salvage value or the useful life. 364 U.S. at 105 (emphasis added).

The Court rejected the taxpayers' unrealistic computations as based on a "false assumption" and said that "correct tabulations, not artificial ones, [must] be used" in computing depreciation whenever possible. 364 U.S. at 105, 101. The Court noted that by use of these "false" and "artificial" assumptions, the taxpayers were deducting more depreciation than the "actual cost" of the asset, thus "convert[ing] the inflated amounts [of depreciation] from income taxable at ordinary rates to [gain on sale of the assets] * * * taxable at the substantially lower capital gains rates. This, we believe, was not in the design of Congress." "Congress intended by the depreciation allowance not to make taxpayers a profit thereby, but merely to protect them from a loss." 364 U.S. at 97, 101.

In *Hertz Corp.* v. *United States,* 364 U.S. 122, decided the same day as *Massey* and *Evans,* the Court considered a closely related question: whether a taxpayer using the declining balance method could depreciate an asset below its estimated resale value. The Court stated that there is an "overriding statutory requirement that the depreciation deduction be a *reasonable* allowance" (emphasis in original), and that permitting a taxpayer to depreciate an asset below salvage value "would permit a *knowing distortion*

of the expense of employing the asset in the years after that point is reached" (364 U.S. at 127, emphasis added). Thus, the Court refused to allow depreciation "beyond what reasonably appears to be the price that will be received when the asset is retired." *Ibid.*

While *Massey, Evans,* and *Hertz* did not deal with the exact question presented here, we believe that the principles upon which those decisions were based are particularly apposite here. In those cases, the Court recognized that the "fundamental concept of depreciation" is to give the taxpayer a deduction for the actual net cost of an asset, 364 U.S. at 128, and that estimates are used only because the resale price is not known. Thus in computing the depreciation deducted for each year, the taxpayer must use the most accurate possible estimates in light of all the circumstances known to exist at the year end; he cannot "knowing[ly] distort" income by depreciating the asset below "what reasonably appears to be the price that will be received when the asset is retired." The one exception is that he need not re-estimate salvage value "merely because of changes in price levels." With this single exception, he may not use "artificial" or "false assumption[s]" in order to "make * * * a profit" by transforming ordinary income into capital gain (or, as here, into nontaxable gain). When the asset has been sold the taxpayer, instead of knowingly using a "false assumption," must em-

ploy the "real salvage price."[9] To permit petitioner to take a depreciation deduction for 1957 would, as the court below observed, give it "an allowance [it] * * * knows to be fictional at the time [it] * * * claims it" (R. 81).

D. A TAXPAYER WHO KNOWS THAT HIS USE OF AN ASSET IS COSTING HIM NOTHING IS NOT ENTITLED TO A DEPRECIATION DEDUCTION

There is nothing unusual or startling about the result we seek, *i.e.*, that although petitioner used the *Feuer* for all but eight days of 1957, it will not receive any depreciation deduction for that year. In general, the Internal Revenue Code taxes net monetary income. A taxpayer is not entitled to a deduction (depreciation or otherwise) if he need not and does not

[9] The Court's opinion in *United States* v. *Ludey*, 274 U.S. 295, cited and relied upon by petitioner, is consistent with these basic principles. Because of the structure of the tax laws in 1917, the issue presented here did not exist in *Ludey*. See, *infra*, fn. 23. However, the Court's language clearly implied that total depreciation plus salvage value should, as nearly as possible, "equal" the asset's "original cost." It certainly lent no support to petitioner's contention that additional depreciation deductions should be permitted after the taxpayer knows that "the aggregate of the sums [already deducted plus] * * * the salvage value * * * equal * * * the original cost." 274 U.S. at 300-301.

In *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 102, the Court said "that the taxpayer's outlay is the measure of his recoupment through depreciation accruals." And, in *Virginian Hotel Corp.* v. *Helvering*, 319 U.S. 523, 528, the Court stated that a taxpayer who had already taken depreciation deductions cannot take a "second deduction" for the same depreciation. While again the issue was not presented there, we believe that these cases also reflect the philosophy that a taxpayer cannot intentionally deduct more depreciation than the known actual net cost of the asset.

pay out any money. Thus if an employer receives $10,000 worth of services from an employee, but because of a favorable employment contract the employer is obliged to pay only $1,000 in salary, he is entitled to only a $1,000 tax deduction.

Similarly, if because of unusual market conditions a taxpayer pays $1,000 for an asset that normally would cost him $10,000, he is entitled to only $1,000 of depreciation regardless of how long he uses the asset. Moreover, if he reasonably expects to use the asset for 10 years and then to resell it for $1,000, he is not entitled to any depreciation even though the asset declines in value $9,000 because of wear and tear. See, *e.g.*, *Massey Motors* v. *United States*, 364 U.S. 92.

At the end of 1957, petitioner knew that its use of the *Feuer* for two years had cost it nothing. It was thus entitled to no depreciation deduction for 1957. The fact that petitioner had received reasonable but, as it turned out, completely unwarranted depreciation deductions in previous years (1955 and 1956) scarcely furnishes a reason for granting it an additional excessive deduction in the year of sale (1957) when it *knew* that it had incurred no monetary cost for using the *Feuer*. See, *e.g.*, *Hertz Corp.* v. *United States*, 364 U.S. 122, where this Court denied the taxpayer any depreciation deduction for those years after it had depreciated its cost basis in the assets down to their expected resale price.[10]

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[10] Petitioner cites the Regulation providing that "The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service." Treas. Reg. § 1.167(a)-10(b). Of course, in the vast number of

II

PETITIONER'S RELIANCE ON COMMERICAL ACCOUNTING PRACTICE IS WITHOUT MERIT

Petitioner's reliance on "business accounting principles" (Pet. Br. 12–18, American Automotive Br. 37–40, S & A Co. Br. 13–18) is plainly misplaced. This Court has repeatedly held that generally accepted commercial accounting practices are not controlling when they fail clearly to reflect income for tax purposes. *American Automobile Assn.* v. *United States,* 367 U.S. 687, 692–694; *Commissioner* v. *Hansen,* 360 U.S. 446; *Bazley* v. *Commissioner,* 331 U.S. 737, 741; *Brown* v. *Helvering,* 291 U.S. 193, 202–203.[11]

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cases where an asset is scrapped or sold without a gain, a taxpayer is entitled to take depreciation deductions up to the date of sale. That Regulation does not, however, state that a depreciation deduction shall in all cases be allowed up to the date an asset is retired from service. It merely reiterates the general rule that "*The period for depreciation* * * * shall end when the asset is retired" (emphasis added). Of course, whether depreciation deductions are allowable for the full period of use depends on the facts in the particular case and the other provisions of the Regulations relating to the computation of depreciation deductions. See, *e.g.*, Treas. Reg. § 1.167(b)-0. Certainly even petitioner would not contend that a taxpayer who continues to use an asset after he has already depreciated all of its original cost would be entitled to additional depreciation deductions during "the period [until it] * * * is retired from service." See, *e.g.*, *Hertz Corp.* v. *United States*, 364 U.S. 122.

[11] The cases cited by petitioner are not to the contrary. In *Stratton's Independence, Ltd.* v. *Howbert*, 231 U.S. 399, 423, the Court expressly refused to consider whether depreciation as "charged in practical bookkeeping" had any bearing on tax liability. In *Von Baumbach* v. *Sargent Land Co.*, 242 U.S. 503, 524, the Court reached only the conclusion that Congress had,

The difference between the accountants' and the taxing authorities' treatment of year of sale depreciation stems from a divergence in the purpose each seeks to accomplish. For tax purposes a taxpayer is entitled to periodic deductions equal in amount to the net cost of the asset. If, because of the necessary use of estimates, the taxpayer takes these deductions too quickly, he is not entitled to any more. For example, if a taxpayer reasonably estimates that a machine he purchased for $10,000 in 1931 will be retired in 1941 with negligible scrap value, he would deduct $1,000 annually. If, however, because of the Second World War the taxpayer continued to use the fully depreciated machine until 1945, he would be entitled to no further depreciation during the last years of use. See, *e.g.*, *Hertz Corp.* v. *United States*, 364 U.S. 122.

On the other hand, accountants who are preparing financial statements for stockholders have a much different purpose in mind. Their main interest is in avoiding any overstatement of current net income from operations—a matter crucial to investors in evaluating securities. The accountant is thus not necessarily concerned that the total depreciation de-

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in general, meant the same thing by "depreciation" as business men understood it to be and that this did not include depletion of mineral deposits. It did not hold that every detail of tax depreciation was controlled by accounting principles. And in *Real Estate Title Co.* v. *United States*, 309 U.S. 13, 16, the Court said that "obsolescence" in the tax statute connotes functional depreciation "as it does in accounting and engineering terminology". It did not say that it was so *because* accounting or engineering terminology controlled tax liability.

ductions (including those in the year of sale) have exceeded an asset's actual net cost, so long as net operating income for the current year is not exaggerated. The accountant can balance the books by crediting the excessive year-of-sale depreciation to a special non-recurring income account.

Since the reasons for the accountants' policy of excessive year-of-sale depreciation differ radically from the income tax purpose of depreciation deductions, they are hardly controlling upon the taxing authorities. We note, indeed, that even the accounting works on which petitioner relies recognize that accounting for business purposes and accounting for tax purposes may be, and usually are, two different things. See, *e.g.*, I Dewing, *Financial Policy of Corporations* (5th ed.), p. 540, fn. h: "it should be observed at the outset of any discussion of depreciation that the connotations of the term itself and the implications are used differently by accountants and by the income tax auditors—state as well as federal." See also, *id.*, pp. 540–541, fn. i, and p. 542, fn. i. Dewing states further that "In all this voluminous literature pertaining to depreciation found in accounting, legal and business periodicals, there is surprisingly little unanimity of opinion," and that "The law governing the practical application of the principle of depreciation to corporate accounts is as confused as are the principles tolerated by business executives and accountants in their actual practices." *Id.*, pp. 539–540, fn. g, and p. 541, fn. i.

III

NO OTHER PROVISION IN THE CODE CONFLICTS WITH THE COMMISSIONER'S INTERPRETATION OF SECTION 167

A. SECTION 1231 DEALS ONLY WITH HOW GAIN, IF ANY, ON THE SALE OF A DEPRECIABLE ASSET SHALL BE TAXED

Petitioner argues that although its use of the *Feuer* cost it nothing, it is nevertheless entitled to a $135,000 depreciation deduction in 1957 because the decline in an asset's value due to wear and tear in the year of sale should not be offset against the increase in its value due to market appreciation. According to this argument, any increase in the value of a depreciable asset between the time of its purchase and the date of its sale should be taxed as capital gain. A taxpayer would be deprived of a part of this capital gain treatment if he were prohibited from depreciating the asset in the year it was sold at a profit.[12] (Of course, since petitioner sold the *Feuer* as part of a 12-month liquidation under Section 337 of the Code, the resulting increased profit on sale would not even be subject to the capital gains tax.)

We submit two answers to this argument.[13]

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[12] Petitioner and American Automotive apparently are not in agreement regarding the scope of this theory. Petitioner's brief indicates that it might be proper to disallow year-of-sale depreciation if the asset is "sold at or near the end" of its originally estimated useful life. (Pet. Br. 50.) American, on the other hand, would apply the theory to require the allowance of year-of-sale depreciation regardless of when the property is sold. (American Br. 11–12, 49.)

[13] The same argument, we note parenthetically, was presented at length by all three taxpayers in the *Massey*, *Evans* and *Hertz* cases (see brief for the petitioner in *Massey Motors*, No. 141 at

First, the short answer is that in granting capital gain for profits on sales of depreciable assets Congress made no effort to prescribe any methods for computing depreciation. Section 1231 and its predecessor [14] merely state that profits, if any, resulting from the sale or exchange of certain types of property shall be taxed as capital gain. Nothing in the language or history of that provision indicates any Congressional intent to affect in any manner the orderly judicial elaboration of the phrase "a reasonable allowance for" "depreciation" in Section 167. Nor is there any evidence that Congress sought to withdraw the power it had expressly given the Secretary of the Treasury or his delegate to issue "regulations" governing the manner in which "an allowance [for depreciation shall be] computed" (Code § 167(b)), pursuant to which the Regulations discussed *supra* were promulgated.

The Commissioner and petitioner agree that Section 1231 requires any gain recognized on the sale of the *Feuer* to be taxed as capital gain (in fact, because of Code § 337 no gain was recognized). However, the sole question presented by this case is whether petitioner is entitled to $135,000 of depreciation in 1957

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the October Term, 1959, pp. 32–33; brief for the respondent in *Evans*, No. 143 at the October Term, 1959, pp. 71–83; and brief for the petitioner in *Hertz*, No. 283 at the October Term, 1959, pp. 69–80), and plainly not accepted by the Court. In fact, the court of appeals in *Evans* v. *Commissioner*, 264 F. 2d 502, 513–514 (C.A. 9), relied on this argument in holding against the Commissioner. This Court reversed that decision, *sub nom. Massey Motors, Inc.* v. *Commissioner*, 364 U.S. 92.

[14] Int. Rev. Code of 1939, § 117 (j), added by Rev. Act of 1942, § 151(b), 56 Stat. 846, 26 U.S.C. (1952 ed.) § 117(j).

(the year of sale) which, of course, would increase its unrecognized gain on sale by that amount. Seeking aid in Section 1231 merely begs that question.

Second, petitioner's argument is anchored to the premise that Congress intended taxpayers to get capital gain treatment for all increases in an asset's value due to market appreciation. Based on this premise it is argued that depreciation deductions should never be reduced because of increases in an asset's value after its purchase, because that would prevent the taxpayer from receiving capital gain treatment on the full appreciation. We challenge the premise.

It is not at all unusual for the allowance for depreciation to be reduced because of expected or actual increases in market values after the date of purchase. The first step a taxpayer must take in ascertaining the portion of his purchase price that can be depreciated is to deduct the estimated resale value of the asset at the end of its useful life. If, for example, the taxpayer purchases a ship for $500,000 and expects to use it for three years and then resell it, he must make the best possible estimate of its resale value at the end of that period. If because of a current oversupply of such ships, used vessels of that nature were, at the time of the taxpayer's purchase, selling for only $100,000, but it was reasonably foreseeable that the market would firm up within three years (perhaps to $200,000), the taxpayer must estimate a salvage value equal to the higher resale price expected in three years. In such a case he must use the latter figure in computing depreciation. There-

fore, to the extent that a rise in the second-hand value of the asset between the time of its purchase and the time of its expected sale can be foreseen, the taxpayer is prohibited from taking depreciation and prevented from getting capital gain on this increase in market value. This, of course, pierces the core of petitioner's claim as to the significance of Section 1231 in computing depreciation.

Moreover, other aspects of the computation of depreciation refute petitioner's argument even more forcefully. Focusing again on the taxpayer in the above example (who purchased a ship for $500,000 with the intention to use it for 3 years at which time he expected to resell it for $200,000), he would take $100,000 of depreciation the first year (500,000 less $200,000÷3). Assume that near the end of the taxpayer's second year of use an international crisis of apparently long duration (*e.g.,* the Korean conflict) developed and in light of these conditions the taxpayer then expected to use the ship for a total of 5 years (instead of three). Because of the taxpayers significant change in expected useful life he is required to adjust the depreciation formula for that year and for future years. As a part of this adjustment the taxpayer is required to re-estimate the ship's resale value "based upon facts known at the time of such redetermination of useful life." Treas. Reg. § 1.167(a)-1(b), (c). Therefore, if the second-hand value of such ships had increased during the two years that elapsed between taxpayer's purchase of the ship and his re-estimate, his depreciation deductions would be reduced solely because of the in-

crease in the ship's market value. For example, if, because of the crisis, the expected second-hand value of such ships had shot up from $200,000 to $400,000, the taxpayer would not be entitled to any further depreciation deductions during the last four years of use. And if, as anticipated, the taxpayer eventually sold the ship for $400,000, he would have no gain or loss on the disposition.[15]

The basic structure of the scheme of depreciation deductions thus destroys the bald suggestion that Congress meant taxpayers to get capital gain on the full amount of an asset's appreciation in value, even if such a result required depreciation in excess of the asset's known or reasonably expected net cost.

B. NEW SECTIONS 1245 AND 1250 ALSO DEAL EXCLUSIVELY WITH THE TAXATION OF GAIN ON DISPOSITION OF AN ASSET, AND NOT WITH THE COMPUTATION OF DEPRECIATION DEDUCTIONS

Nor do the recently enacted Sections 1245 and 1250 of the Code impair the Commission's position here. Those sections (enacted in 1962 and 1964, respectively)[16] were aimed at prospectively altering the

[15] Neither petitioner nor the *amici* suggest that the Regulations which require this result are invalid. In fact, their briefs indicate that they agree with the requirement that salvage value be revised whenever useful life is adjusted (see, *e.g.*, Pet. Br., pp. 14, 25; S & A Co. amicus br., p. 37; American amicus br., p. 19). Nor do we think petitioner could have attacked the Regulations. We believe that the statutory provision requiring the "allowance [for depreciation to be] computed in accordance with regulations prescribed by the Secretary [of the Treasury] or his delegate" is more than sufficient authorization for this regulation. Code § 167(b).

[16] Revenue Act of 1962, P.L. 87-834, 76 Stat. 960, § 13; Revenue Act of 1964, P.L. 88-272, 78 Stat. 19, § 231.

method of taxing gains, if any, on the disposition of depreciable assets. In general, they provide that in certain carefully defined circumstances a taxpayer's gain on the disposition of depreciable personal property (Section 1245) or depreciable real estate (Section 1250) shall be taxed as ordinary income. Sections 1245 and 1250 (as well as the earlier legislative proposals out of which they arose, see Pet. Br., pp. 34–38) are concerned with the manner in which gains shall be taxed, not with the computation of depreciation. In fact the committee reports explicitly recognize this fact:

> * * * the enactment of this provision is not intended to affect the question of whether all or any part of a claimed deduction for depreciation is in fact allowable. For example, since in the year real property is sold the actual value of the property is known, it has been held that depreciation deductions should not be allowed to the extent they reduce the adjusted basis of the property below the actual amount realized. *This provision,* in providing for ordinary income treatment for certain additional depreciation, *is not intended to affect this holding.* [H. Rep. No. 749, 88th Cong., 1st Sess., p. 103; S. Rep. No. 830, 88th Cong., 2d Sess., p. 133.] [17]

[17] The President's statement to Congress makes it clear that these legislative proposals are directed toward "depreciation * * * deducted * * * by the seller in *previous* years." The President's 1961 Tax Recommendations (H. Doc. No. 140, 87th Cong., 1st Sess., p. 11, emphasis added).

In short, nothing in the language or history of Sections 1245 and 1250 lends any support to petitioner's argument that Congress understood Section 167 (the depreciation section) as authorizing a taxpayer to use a known-to-be-wrong estimated resale price in computing depreciation for the year an asset was sold.[18]

IV

THERE IS NO LONG-STANDING ADMINISTRATIVE PRACTICE CONTRARY TO THE COMMISSIONER'S POSITION

Petitioner argues that in "more than four decades of administrative practice and rulings" the Commissioner has permitted year-of-sale depreciation, and that this consistent position "has been elevated to a rule of law by repeated statutory reenactment." (Pet. Br., p. 18.) We disagree.

In support of its position petitioner cites four published rulings of the Internal Revenue Service, none of them later than 1927. Three of these four rulings dealt with tax years before Congress first enacted any provision for capital gain.[19] Before 1921, the gain on sale of a depreciable asset was taxed as

[18] The enactment of Sections 1245 and 1250 does not render the issue presented in the instant case unimportant. First, those sections apply only to depreciation taken after the date of their enactment (1962 for personal property and 1964 for real estate). And second, at least with regard to real estate, this Court's decision in the instant case will play a significant role even after the new sections are fully effective. If a taxpayer holds real property for at least 10 years, the sections will be inapplicable, and if he holds it between 20 months and 10 years, they will be only partially applicable, depending on the length of the holding period.

[19] There was no provision for capital gain until the Revenue Act of 1921, 42 Stat. 227, § 206(a).

ordinary income; therefore, it made no difference in tax liability whether year-of-sale depreciation was allowed on assets sold at a gain. If, for example, $1,000 of depreciation were disallowed in the year of sale, operating income would be increased by $1,000 and the gain on sale would be decreased by the same amount. Since both were taxable as ordinary income there would have been no tax effect. Thus in three of the four rulings cited by petitioner the issue with which we are here concerned, even if presented, would not have been considered, since it could have made no difference in the amount of tax to be collected.

In the fourth ruling cited the Bureau altogether failed to focus upon the issue presented here, *i.e.,* the allowability of a depreciation deduction in the year of a profitable sale of the asset. The facts stated do not enable the reader to ascertain whether the taxpayer actually had a gain on the sale of the asset.[20] Moreover, that ruling (which was merely a General Counsel's Memorandum) was concerned with the difficult problem of allocating depreciation deductions on real estate held in trust between the life tenant, the remainderman and the trustee. G.C.M. 1597, VI-1 Cum. Bull. 71 (1927). Patently, there was no focus upon the question presented here (even if there were a gain), and the offhand reference to de-

[20] While the ruling states that the real estate was sold "at an advance" over its appraised value at the testator's death, it does not indicate whether the taxpayer spent money on improvements or otherwise increased his basis in the property. In fact, the ruling states that the taxpayer had inquired about the method of determining whether there was a "gain or loss from * * * sale."

preciation up to the time the property was sold cannot possibly be treated as a considered determination.[21] Finally, as this Court has noted more than once, the front cover of the Cumulative Bulletins expressly states that such rulings, not having been "formally approved and promulgated by the Secretary of the Treasury," "have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law." See *Dixon* v. *United States,* 381 U.S. 68, 73; *Helvering* v. *New York Trust Company,* 292 U.S. 455, 468.

Petitioner also relies on the position taken by the Commissioner in a number of cases, mostly before the Board of Tax Appeals in the 1920's. In many of these cases the Commissioner did permit depreciation up to the date of sale. However, virtually all of these cases arose within a few years after the advent of the income tax when the Commissioner and the courts were fully occupied with establishing the basic ground rules for computing depreciation and determining the amount of gain on sale. In none of those early cases

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[21] Nor did the three rulings which dealt with the pre-capital gain years discuss or consider this question. In fact in one of them it was clear from the facts stated that the taxpayer did not have a gain on the sale of the asset. I.T. 1494, I-2 Cum. Bull. 19 (1922). Another dealt in general terms with assets "abandoned or scrapped" on which a taxpayer would seldom be expected to recognize a gain. I.T. 1158, I-1 Cum. Bull. 173 (1922). Although the remaining one apparently concerned a profitable sale, it was merely a half-page statement of the conclusion reached by the Committee on Appeals and Review in a particular case dealing with both depletion and depreciation without stating the facts and without exhibiting any awareness of the issue presented here. A.R.R. 6930, III-1 Cum. Bull. 45 (1924).

was either the Commissioner's or the courts' attention focused on the issue presented here. Rather (with two minor exceptions, discussed *infra*, p. 38), all of the cases were concerned solely with other complicated issues of depreciation which held the Commissioner's and the courts' attention.

For example, a substantial number of the cases cited by petitioner involved the fundamental issue whether, in computing either depreciation or gain or loss on an asset acquired before 1913, the taxpayer must use the asset's cost or its value on March 1, 1913. Moreover, most of the cases also involved taxpayers who had deducted no depreciation at all; thus the question presented to the courts was whether, when these assets were sold, the taxpayers had to reduce their cost basis for the assets by the amount of depreciation they could have deducted. Many of the cases contained both this issue and the pre-1913 problem.[22] Thus, while most of the cited cases contain an offhand reference to depreciation from the date of acquisition to the time of sale, it is clear that neither the Commissioner nor the courts actually con-

[22] Other cases cited by petitioner involved such questions as whether a taxpayer should have deducted depreciation on an idle factory, whether another taxpayer could have deducted depreciation on unprofitable real estate, and whether a trustee who was previously not permitted to deduct depreciation on assets held in trust must nevertheless reduce his cost basis for those assets. Again these cases centered on the Commissioner's attempts to reduce the taxpayer's cost basis by the amount of depreciation he had never deducted. And again the Commissioner and the courts never addressed themselves to the period of depreciation as opposed to the allowability of depreciation on such assets in general.

sidered whether depreciation should be allowable in the year of a profitable sale. Instead, their full attention was directed elsewhere.[23]

In only two of the cases dealing with pre-1938 tax years was the deductibility of depreciation in the year of a profitable sale actually considered, and there only in a passing manner. Moreover, in those two cases the Commissioner with equal success took inconsistent positions, disallowing such depreciation in one case and allowing it in the other. Compare *Duncan-Homer Realty Co.* v. *Commissioner,* 6 B.T.A. 730, with *Herbert Simons* v. *Commissioner,* 19 B.T.A. 711.

In 1938 Congress withdrew depreciable assets from the scope of the capital gains provisions, and from then until 1942 the issue here presented was again (as in pre-1921 tax years) irrelevant to tax liability. In 1942 the predecessor to present Section 1231 was enacted,[24] so that taxpayers might again, under speci-

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[23] Both *United States* v. *Ludey*, 274 U.S. 295, and *Eldorado Coal & Mining Co.* v. *Mager*, 255 U.S. 522, cited and heavily relied upon by petitioner, were decided under the Revenue Act of 1917 (*i.e.*, before the advent of capital gain), and thus the issue presented here was neither presented nor considered. In fact, *Eldorado* was concerned with a constitutional problem and *Ludey* dealt with the basic question whether (in the absence of a statute so providing) an asset's cost basis had to be reduced by the amount of depreciation a taxpayer was entitled to deduct. Moreover, the only offhand reference to year-of-sale depreciation in either opinion is a statement that "*It is averred in the declaration* that, * * * subtracting depreciation and depletion to the date of sale, it appears that there was" a gain on sale. 255 U.S. 526 (emphasis added).

[24] Internal Revenue Code of 1939, § 117(j), added by Revenue Act of 1942, § 151(b), 56 Stat. 846, 26 U.S.C. (1952 ed.) § 117(j).

fied circumstances, receive capital gain treatment on profits from the sale of depreciable property. Shortly thereafter, the Commissioner, apparently for the first time, focused on the significance of the issue presented in the instant case. In two well known and hard-fought cases the Commissioner disallowed depreciation deducted in the tax years 1942 and 1944, *i.e.*, the year the change in law revitalized the issue and two years later.

In *Wier Long Leaf Lumber Co.* v. *Commissioner*, 9 T.C. 990,[25] the Commissioner challenged the deductibility of 1942 depreciation on a sawmill and three automobiles which the taxpayer had sold at a substantial gain during that year. The facts there were quite similar to the instant case; "by reason of war conditions existing throughout 1942, the price for which the mill and mill equipment could be sold was far in excess of the estimated salvage value" (9 T.C. at 992), while here the Suez crisis had the same effect. After noting that for some time before 1942 the issue had been academic, the court upheld the Commissioner's disallowance of year-of-sale depreciation with respect to the sawmill (9 T.C. at 998):

> In the present taxable year [*i.e.*, the year of sale] petitioner had all of the facts before it upon which it could compute an accurate amount to be deducted by it as its depreciation allowance for that year. In order to arrive at the correct amount [of depreciation], i.e., the

[25] The Tax Court's decision on an unrelated excess profits tax issue was affirmed in part and reversed in part, 173 F. 2d 549 (C.A. 5), but the depreciation issue was not mentioned.

> "reasonable allowance" under the statute, it had only to adjust the annual deduction which it proposed to take for the instant year by comparing its basis for the property with the total deductions previously taken and the current ascertained correct salvage value. * * * In this manner depreciation can be kept to an accurate provision for the return of petitioner's capital investment in the property. That is what the law contemplates. * * *

Thus with regard to the sawmill the Commissioner and the court took exactly the position we maintain here. However, without stating any persuasive distinction, the court held to the contrary with regard to the three automobiles.

Our inability to reconcile the Tax Court's two inconsistent holdings is not crucial. What is significant for purposes of this case is that almost immediately after the 1942 change in law the Commissioner focused on the problem and took the position we advocate here. Whether the Commissioner won the *Weir* case in part or in whole is, we believe, far less important.[26]

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[26] The Commissioner at first noted his acquiescence in the Tax Court's decision, 1948-1 Cum. Bull. 3, but later withdrew it and substituted his non-acquiescence, 1962-1 Cum. Bull 5. While it is not clear why the Commissioner initially acquiesced in the Tax Court's internally inconsistent holdings, his action does not constitute a binding precedent. The front of each cumulative bulletin clearly explains that rulings of this nature "have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law." See, *e.g.*, *Higgins* v. *Commissioner*, 312 U.S. 212, 215-216; *Dixon* v. *United States*, 381 U.S. 68, 73; *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 468.

In *Cohn* v. *United States*, 259 F. 2d 371 (C.A. 6), the first case to place the issue before a court of appeals, the government disallowed year-of-sale depreciation on assets sold at a gain in 1944 (two years after the change in law). In 1941 the taxpayers had formed flying schools to train military pilots. They reasonably estimated that the assets would be employed in their business until 1944 but erroneously used a zero salvage value. The district court held that in light of conditions known to exist in 1941 the taxpayers should have estimated the assets would be resold for at least 10 percent of cost. The court thus used a 10 percent salvage value in computing 1942 and 1943 depreciation. But the district court held that since the taxpayers sold the assets in 1944 for more than their depreciated cost at the beginning of the year, they were not entitled to any depreciation in 1944, the year of sale.

Neither the taxpayers nor the government disagreed with the district court's holding that 10 percent of cost constituted a reasonable estimate of salvage for computing 1942 and 1943 depreciation. The taxpayers, however, appealed from the district court's disallowance of all year-of-sale depreciation. The court of appeals affirmed and, in its opinion, stated the government's position as follows:

> the Government is not contending that salvage value should be adjusted annually in order to conform with current market values, or that it should be adjusted at all on account of "mere fluctuation in market value." [Rather the government seeks to adjust salvage value only] when it is shown by an actual sale of the asset that there is a substantial difference between

what was estimated and what it actually is. * * * Under such circumstances the practical difficulties urged upon us are largely nonexistent. [259 F. 2d 378.]"[27]

Thereafter, the Commissioner issued the first published ruling which dealt definitely with the issue. That ruling specifically stated that "the deduction for depreciation of an asset * * * in the year of disposition * * * is limited to the amount, if any, by which the adjusted basis of the property at the beginning of

[27] Petitioner cites an example in the Regulations relating to the sale of emergency facilities subject to Section 168's special 60-month amortization. In general, Section 168 permits a taxpayer who has obtained certification that a certain portion of his newly constructed facilities are "necessary in the interest of national defense during the emergency period" to write off the cost of these facilities, against income over a period of 60 months. In 1951 Congress enacted the predecessor to present Section 1238, providing that if a taxpayer should sell such emergency facilities any portion of the profit which was caused by Section 168's accelerated write-off shall be taxed as ordinary income. One of the examples in the Regulations issued under Section 1238's predecessor does in fact indicate that depreciation would be allowed in the year of a profitable sale. Treas. Reg. 111, § 29.117-9(a), added in 1951, republished as Treas. Reg. § 1.1238-1, example (1), to the 1954 Code. However, it is quite clear that the draftsman's attention was not focused on that issue, but rather on the complex interaction of Sections 168 and 1238. The Regulation has since been amended (retroactive to its original adoption in 1951) to reflect the Commissioner's position stated herein. T.D. 6825, 1965-26 I.R.B. 6. In any event, the existence of this obscure and unconsidered aspect of an example in a Regulation intended to illustrate another provision entirely, while the Commissioner was at the same time judicially attacking the deductibility of such depreciation, lends little support to petitioner's contention of "more than four decades of administrative practice and rulings." (Pet. Br., p. 18.)

such year exceeds the amount realized from sale or exchange." Rev. Rul. 62-92, 1962-1 Cum. Bull. 29, Appendix, *infra*, pp. 53, 54.

The next two cases to reach the courts of appeals were also decided in favor of the government. (The instant case, 335 F. 2d 15 (C.A. 2); and *United States* v. *Motorlease Corp.*, 334 F. 2d 617 (C.A. 2), now pending on petition, No. 24, this Term.) The Tax Court, which at first was in full agreement with the Commissioner, has more recently adopted a set of complicated tests which are exceedingly difficult to administer and require a complete examination of the detailed facts of each case. See, *e.g.*, *Macabe Co.* v. *Commissioner*, 42 T.C. 1105 (five dissents), on appeal to C.A. 9.[28] One court of appeals has now followed the Tax Court. *United States* v. *S & A Co.*, 338 F. 2d 629 (C.A. 8), pending on petition, No. 50, this Term. In brief, while the cases in the lower courts are in irreconcilable conflict, no court has refused to reach the merits on the ground that Congressional reenactments foreclose the issue.

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[28] Contrary to petitioner's contention the Tax Court continues to disallow depreciation in the year of a profitable sale unless the taxpayer demonstrates that he qualifies under the complex rules laid down by that court, even when the reasonableness of the original estimates, when made, was not questioned. See, *e.g.*, *Miller* v. *Commissioner*, decided November 20, 1964 (P-H Memo T.C., par. 64,305); *Bell Lines, Inc.* v. *Commissioner*, 43 T.C. 358; and *The Covered Wagon, Inc.* v. *Commissioner*, decided April 5, 1965 (P-H Memo T.C., par. 65,079). In fact, in the *Macabe* case itself the Tax Court stated that it would adhere to the result it had previously reached in this case, *i.e.*, disallowance of petitioner's year of sale depreciation. 42 T.C. at 1110-1111.

Based on these facts, we submit that before 1942 there was no considered and consistent administrative practice and that to the extent any practice has developed in the years since 1942, it lends support to the Commissioner's position.

In addition, it is clear that there was no long-settled administrative practice of the kind that would be necessary to preclude the Commissioner's present position. As this Court said in *Higgins* v. *Commissioner,* 312 U.S. 212, 215–216:

> No regulation has ever been promulgated which interprets the [statutory phrase here in question] * * *, nor any rulings approved by the Secretary of the Treasury, i.e., Treasury Decisions. Certain rulings of less dignity, favorable to [the taxpayer] appeared in individual cases but they are not determinative. Even acquiescence in some Board [of Tax Appeals] rulings after defeat does not amount to settled administrative practice. *Unless the administrative practice is long continued and substantially uniform in the Bureau and without challenge by the Government in the Board and courts, it should not be assumed, from rulings of this class, that Congressional reenactment of the language which they construed was an adoption of their interpretation.* [Emphasis added.]

Similarly, in *Helvering* v. *Reynolds,* 313 U.S. 428, 430–431, the Court disregarded two contrary rulings published by the Bureau of Internal Revenue and at least two contrary court of appeals decisions:

> [These] office decisions of the Treasury, and * * * decisions of the lower federal courts * * * [did not] demonstrate that the earlier rule had become embedded in the law so that it could be changed not by administrative rules or regulations but by Congress alone. * * *

See also *Helvering* v. *New York Trust Co.,* 292 U.S. 455, 467–468; cf. *Dixon* v. *United States,* 381 U.S. 68.[29]

Moreover, in these cases the Court refused to apply the doctrine of Congressional reenactment on the basis of published ITs, GCMs, acquiescences and lower court decisions despite the fact that the Internal Revenue Service and the lower courts had focused upon the problem and reached a considered decision. In the instant case, on the other hand, neither the one GCM in which the issue may have been present nor the early lower court decisions cited by petitioner recognized or considered the issue; rather, the answer "was assumed without question and without an explicit holding on the point." *Jones* v. *Liberty Glass Co.,* 332 U.S. 524, 533, fn. 16.

In short, petitioner's elaborate attempt to make it appear that the Commissioner's position in Rev. Rul. 62–92 and this case runs counter to a long-established

[29] Two earlier cases which relied upon lower level rulings not reviewed by the Secretary of the Treasury (*McFeely* v. *Commissioner*, 296 U.S. 102, and *Helvering* v. *Bliss*, 293 U.S. 144) were explicitly rejected in *Higgins* v. *Commissioner*, 312 U.S. at 216, fn. 10. See also *Helvering* v. *Reynolds*, 313 U.S. at 430–431.

and Congressionally recognized construction of the statute lacks any concrete foundation.[30]

CONCLUSION

When at the end of its 1957 taxable year petitioner sought to take a $135,000 depreciation deduction on its 1957 tax return, it knew that its use of the *Feuer* (which had already been resold) had cost it nothing. Its argument that it is nevertheless entitled to depreciation is bottomed on the use of an "artificial" and "false assumption" as to the ship's resale value, which at the end of 1957 it knew to be significantly inaccurate. Petitioner cannot "knowing[ly] distort" income and use the deduction for depreciation to intentionally "make * * * a profit." The explicit provisions in the Regulations prohibiting a taxpayer from depreciating an asset below salvage value, the holdings of this Court that depreciation is to be computed in a common sense and realistic manner, and Congress' purpose in enacting the depreciation statute that a taxpayer should be entitled to deduc-

[30] As we have shown, in the only reference to this issue in any of the legislative history, two Congressional committees indicated that they did "not intend to affect" the holding of the lower courts "that depreciation deductions should not be allowed [in the year of sale] to the extent they reduce the adjusted basis of the property below the actual amount realized." See *supra*, p. 33.

In any event, even if petitioner were correct, this Court has often held that "prior administrative practice is always subject to change 'through exercise by the administrative agency of its continuing rulemaking power.'" *Commissioner* v. *P. G. Lake*, 356 U.S. 260, 266, fn. 5; see also, *e.g.*, *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 183; *Manhattan General Equipment Co.* v. *Commissioner*, 297 U.S. 129, 134.

tions which are as close as possible to the actual net cost of the asset, all preclude petitioner from deducting depreciation on the *Feuer* after having sold it for more than its depreciated cost. The judgment of the court of appeals should therefore be affirmed.

Respectfully submitted.

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OCTOBER 1965.

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*In lieu of the Solicitor General, who has disqualified himself.

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Respectfully submitted,

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Acting Solicitor General.

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APPENDIX

Internal Revenue Code of 1954:

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) *Use of certain methods and rates.*—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

* * * * *

[26 U.S.C. 167.]

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) *General Rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof)

of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * * *

[26 U.S.C. 1231.]

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.167(a)–1 *Depreciation in general.*

(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property * * *. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value. * * *

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the tax-

payer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.* Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price

levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. * * * Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation, or by a reduction in the rate of depreciation, but in no event shall an asset or an account be depreciated below a reasonable salvage value. * * *

* * * * *

Sec. 1.167(a)–10 *When depreciation deduction is allowable.*

* * * * *

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. * * *

* * * * *

Sec. 1.167(b)–0 *Methods of computing depreciation.*

(*a*) *In General.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally,

depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

*   *   *   *   *

Sec. 1.167(b)-1 *Straight line method.*

(a) *Application of method.* Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. * * *

*   *   *   *   *

Rev. Rul. 62-92, 1962-1 Cum. Bull. 29:

> The depreciation deduction for the taxable year of disposition of an asset used in the trade or business or in the production of income, otherwise properly allowable under the taxpayer's method of accounting for depreciation, is limited to the amount, if any, by which the adjusted basis of the asset at the beginning of the year exceeds the amount realized from sale or exchange.

Advice has been requested whether the Internal Revenue Service will apply the decision of the United States Court of Appeals in the case of *Bertrand W. Cohn, et al.,* v. *United States,* 259 Fed. (2d) 371, (1958), to the extent that the deduction for depreciation of an asset used in a trade or business will be adjusted in the year of disposition of the asset if the amount received from disposition exceeds the adjusted basis of the asset as of the beginning of the taxable year.

*   *   *   *   *

The provision in section 1.167(a)-1(c) of the regulations to the effect that salvage value shall

not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels applies to assets still on hand. The provision does not preclude adjustment of salvage value where there is a clear and convincing basis therefor even though no adjustment of useful life is required. The purpose of the provision is to eliminate needless and endless controversies over depreciation allowances which at best are merely informed estimates of the cost of using the property in the taxpayer's business. That purpose has been served when the asset is disposed of and when a final transaction has occurred over which there can be no dispute or difference of opinion or judgment. These rules are and have always been applicable to the allowance of the deduction for depreciation. See *Massey Motors, Inc.* v. *United States* and *Commissioner* v. *Robley H. Evans et ux.*, 364 U.S. 92 (1960), Ct. D. 1847, C.B. 1960–2, 445; and *Hertz Corporation* v. *United States*, 364 U.S. 122 (1960), Ct. D. 1848, C.B. 1960–2, 70.

Accordingly, it is the position of the Service that the *Cohn* case applies equally to the 1939 Code and the 1954 Code and that it is not only reasonable but proper to take the ultimate facts into consideration in determining the depreciation deduction for the year of disposition of the asset. Therefore, the deduction for depreciation of an asset used in the trade or business or in the production of income shall be adjusted in the year of disposition so that the deduction, otherwise properly allowable for such year under the taxpayer's method of accounting for depreciation, is limited to the amount, if any, by which the adjusted basis of the property at the beginning of such year exceeds the amount realized from sale or exchange. See also section 1.167(a)–10 of the regulations for rules with respect to when depreciation is allowable.

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U.S. GOVERNMENT PRINTING OFFICE: 1962